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Reinventing GSEs: Treasury's Plan for Financial Restructuring

By Peter J. Wallison

In late March—timed to impress the G20—the Obama administration revealed its plan for regulating and restructuring the U.S. financial system. There were no surprises; its approach, presented by Treasury Secretary Timothy Geithner, endorsed both a single powerful systemic regulator, with authority to designate and regulate "systemically important" institutions in every financial sector, and a system for liquidating or bailing out financial firms that might cause a systemic breakdown if they failed. Although presented as a way to prevent a repeat of the current financial crisis, the proposals will, if implemented, seriously impair competitive conditions in all U.S. financial markets—enhancing the power of large companies that are designated as systemically important and threatening the survival of those that do not receive that endorsement. Underlying the plan is the erroneous belief—shattered by the catastrophic condition of the heavily regulated banking sector—that regulation can prevent risk-taking and failure. Although the plan could get through Congress if the financial industry remains inert and apathetic, the weakness of the administration's case suggests that it is vulnerable to determined opposition.

The Obama administration and Congress are now filling in the details of a long-anticipated plan for reorganizing and restructuring financial regulation. It is no exaggeration to say that the proposal will create what are essentially government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac in every sector of the financial economy.

The principal elements of the administration's plan are these:

- Establishing a federal agency as the systemic regulator of the financial system
- Giving that agency the authority to designate "systemically important" financial institutions and establish a special regulatory structure for these firms
- Providing a mechanism for the government to take control of financial institutions when and if it decides that their failure will create "systemic risk"

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To be sure, there are differences between the implicit government backing that Fannie and Freddie exploited and a designation as a "systemically important" firm, but in competitive terms, these differences are minor. Designation as a systemically important firm is, in effect, a certification by the government that a firm is too big to fail—its failure, in theory, will create systemic risk—and this status will be seen in the markets as lowering its risk as a borrower. Lower risk will translate into lower

Key points in this *Outlook*:

- A thorough analysis of the Obama administration's financial regulation proposal.
- Firms deemed "too big to fail" will receive competitive advantages.
- A special resolution system will be a recipe for repeated bailouts.
- The cases of AIG and Lehman do not provide a rationale for the administration's plans.
- A systemic risk regulator is not a seer.
- The financial world, largely silent about the administration's proposal, should speak up about its flaws.

funding costs, exactly the advantage that allowed Fannie and Freddie to drive all competition from their market. Indeed, it may well be that the systemically important firms will be more formidable competitors than Fannie and Freddie, which were restricted by their charters from expanding beyond their secondary market role. There is no indication that systemically important firms will be similarly restricted.

In light of the competitive danger that the administration's proposal creates for smaller firms, the lack of any adverse reaction thus far in the financial services sector is surprising. It is also surprising that the administration would back a plan that will inevitably create more firms—rather than fewer—that are too big to fail. It is not hard to understand why the largest firms might not see the plan as a threat; they might believe that the government support they receive will be more helpful than harmful in the future. But it is harder to understand why there seems to be so little vocal opposition at this point from the many smaller firms—insurance companies, securities firms, hedge funds, and finance companies—that will be forced to face government-aided competition. Perhaps they believe that these changes are inevitable. There is little else to explain the support for the idea from such organizations as the U.S. Chamber of Commerce and the Securities Industry and Financial Markets Association—two organizations that are normally skeptical about excessive regulation and object to the government picking winners and losers. This *Outlook* will review the administration's plan in detail, show the weakness of the administration's argument, and outline why and how it will make major changes in the structure of and competitive conditions in the financial sector of the economy.

The Administration's Plan

In congressional testimony on March 26, 2009, Secretary Geithner described the major features of the administration's plan:

> To ensure appropriate focus and accountability for financial stability we need to establish a single entity with responsibility for consolidated supervision of systemically important firms. . . . That means we must create higher standards for all systemically important financial firms regardless of whether they own a depository institution, to account for the risk that the distress or failure of such a firm could impose on the financial system and the economy. . . .
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> [W]e must create a resolution regime that provides authority to avoid the disorderly liquidation of any nonbank financial firm whose disorderly liquidation would have serious adverse consequences on the financial system or the U.S. economy. . . . Depending on the circumstances, the FDIC and the Treasury would place the firm into conservatorship with the aim of returning it to private hands or a receivership that would manage the process of winding down the firm.[1]

The last sentence makes clear that this is not simply a proposal for winding down failed financial institutions in an orderly way; instead, it contemplates a "conservatorship," which would allow the government to take control of a failing company and restore it to financial health. This approach complements the idea that systemically important firms are too big to fail and creates the vehicle that would actually prevent their failure. Underlying the plan, of course, is the glaringly false assumption that regulation can prevent excessive risk-taking and failure by financial firms. One glance at the catastrophic condition of the heavily regulated banking industry should convince anyone who thinks about it objectively that regulation is not the panacea its proponents suggest. The administration has not yet decided what agency would be the systemic regulator, and it has not formally named the agency that would have the authority to take over and resolve or rescue failing or failed nonbank financial firms. The Federal Deposit Insurance Corporation (FDIC) seems to be the frontrunner for the resolution agency; the Federal Reserve has been mentioned frequently as the likely systemic regulator,[2] but this raises serious policy issues.[3]

The Consequences of Designating Firms as Systemically Important

The dangers to competition inherent in the administration's plan arise in two ways: direct benefits to firms that offer products enhanced by the apparent financial soundness of the firm that offers them, and indirect benefits through a lower cost of funds for firms that are perceived to be less risky than their competitors. In insurance, for example, where the financial soundness of a company could make a competitive difference, the companies that can boast that they are too big to fail are likely to be more successful in attracting customers than their smaller competitors. Similarly, but more indirectly, firms that can boast that they are systemically important and thus too big to fail would—like Fannie Mae and Freddie Mac—appear less risky as borrowers than firms that are not protected by the government, and this will produce lower financing costs. Eventually, these firms will be able to use their superior financing opportunities to drive competition from their markets. Overall, the systemically significant firms will be subject to less market discipline, will be able to take more risks than others, will grow larger in relation to others in the same industry, and will gradually acquire more and more of their less successful competitors. Eventually, we will see a market much like the housing market that Fannie and Freddie came to dominate, with a few giant companies, chosen by the government, that have pushed out all significant competition.

It is, of course, possible that the opposite could occur. The companies that are designated as systemically significant could face so much costly regulation that they become less profitable than their competitors. Indeed, some supporters of designating systemically significant firms have argued that systemically important firms will face such onerous regulation that no firm will want the honor. But this seems unlikely. Yes, it is possible to regulate systemically important companies so strictly that they are not able to compete effectively with others, but such a policy would be self-defeating. If regulation so impairs the operations of systemically important companies that they cannot carry on their businesses efficiently, that will only mean they will have to be bailed out sooner. The failure of companies under regulatory supervision is a serious indictment of the regulator's effectiveness, and regulators try hard to avoid it. Regulatory forbearance—refusal to step in and close failing institutions—is a product of this tendency and one of the most significant causes of the savings and loan (S&L) and banking crisis of the late 1980s and early 1990s. So pervasive was regulatory forbearance for S&Ls and banks during that period that a policy called "prompt corrective action" was written into the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the tough banking legislation that was supposed to prevent future widespread bank losses. As discussed below, it has not worked as hoped. Regulatory forbearance seems to continue. The twenty-one banks that have been resolved by the FDIC over the past year have averaged losses on assets of 24 percent,[4] even though prompt corrective action was intended to enable institutions to be closed before they had suffered any losses. Contrary to the notion that regulators could be tough on systemically important firms, experience shows that they try to help their regulated clients succeed.

The Administration's Plan for Resolving or Rescuing Failing Financial Firms

The extraordinary FDIC losses on failing banks should be a warning to anyone who contemplates a nonbankruptcy system for resolving failed or failing financial institutions. In the few cases in which regulators will actually close institutions under the administration's plan, the losses will be expensive for taxpayers. In most cases, however, regulatory forbearance will ensure that excuses will be found to rescue most financial firms, also at taxpayer expense. A rescue not only avoids embarrassment for the regulator but is also generally approved by Congress because it saves jobs and avoids financial disruption. It can be safely predicted, accordingly, that for the largest institutions—those designated as systemically important—the new *resolution* system will simply become a *bailout* system, with the taxpayers handed the bill. The capital markets understand this tendency on the part of regulators. That is why the administration's proposal for a special resolution system for failing financial firms increases the likelihood that the capital markets will see systemically important firms as less likely than others to be allowed to fail, and thus less risky as borrowers.

Secretary Geithner defended this portion of his plan by suggesting that it is merely doing for nonbanks what the FDIC already does for banks. This argument omits the key reasons for FDIC's resolution process—why it exists and who pays for it. Commercial banks and other depository institutions perform a special role in our economy. They offer deposits that can be withdrawn on demand or used to pay others through an instruction such as a check. If a bank should fail, its depositors are immediately deprived of the ready funds they expected to have available for such things as meeting payroll obligations, buying food, or paying rent. Because of fear that a bank will not be able to pay in full on demand, banks are also at risk of "runs"—panicky withdrawals of funds by depositors. Although runs can be valuable and efficient market discipline for insolvent banks, they can be frightening experiences for the public and disruptive for the financial system. The unique attribute of banks—that their liabilities (deposits) may be withdrawn on demand—is the reason that banks, and only banks, are capable of creating a systemic event if they fail. If a bank cannot make its payments to other banks, the others can also be in trouble, as can their customers. That is systemic risk, but it is unlikely to be caused by any other kind of financial institution because these financial institutions—securities firms, hedge funds, insurance companies, and others—tend to borrow for a specific term or to borrow on a collateralized basis. Their failures, then, do not cause any immediate cash losses to their lenders or counterparties. Losses occur, to be sure, but those who suffer them do not lose the immediate access to cash that they need to meet their current obligations. It is for this reason that describing the operations of these nondepository institutions as "shadow banking" is so misleading. It ignores entirely the essence of banking—which is not simply lending—and how it differs from other kinds of financial activity.

> Over time, the process of saving some firms from failure will weaken all firms in the financial sector. Weak managements and bad business models should be allowed to fail.

Because of the unique effects that are produced by bank failures, the Fed and the FDIC have devised systems for reducing the chances that banks will not have the cash to meet their obligations. The Fed lends to healthy banks (or banks it considers healthy) through what is called the discount window—making cash available for withdrawals by worried customers—and the FDIC will normally close insolvent banks just before the weekend and open them as healthy, functioning institutions on the following Monday. In both cases, the fears of depositors are allayed and runs seldom occur. Although Secretary Geithner is correct that the administration's plan would, in effect, extend FDIC bank resolution processes to other financial institutions, for the reasons outlined above, there is much less reason to do so for financial institutions other than banks. Indeed, as discussed below, if the market had been functioning normally in September 2008, both AIG and Lehman Brothers could have been allowed to fail without severe market disruption.

There is also the question of funding. Funds from some source are always required if a financial institution is either resolved or rescued. The resolution of banks is paid for by the premiums that banks pay for deposit insurance; only depositors are protected, and then only up to $250,000. Unless the idea is to create an industry-supported fund of some kind for liquidations or bailouts, the Geithner proposal will require the availability of taxpayer funds for winding up or bailing out firms considered to be systemically important. If the funding source is intended to be the financial industry itself, it would have to entail a very large tax. The funds used to bail out AIG alone are four times the size of the FDIC fund for banks and S&Ls when that fund was at its highest point—about $52 billion in early 2007. If the financial industry were to be taxed in some way to create such a fund, it would put all of these firms—including the largest—at a competitive disadvantage vis-à-vis foreign competitors and would, of course, substantially raise consumer prices and interest rates for financial services. The 24 percent loss rate that the FDIC has suffered on failed banks during the past year should provide some idea of what it will cost the taxpayers to wind up or (more likely) bail out failed or failing financial institutions that the regulators flag as systemically important. The taxpayers would have to be called upon for most, if not all, of the funds necessary for this purpose. So, while it might be attractive to imagine the FDIC resolving financial institutions of all kinds the way it resolves failed or failing banks, it opens the door for the use of taxpayer funds to protect the regulators of all financial institutions against charges that they failed to do their jobs properly.

Sometimes it is argued that bank holding companies (BHCs) must be made subject to the same resolution system as the banks themselves, but there is no apparent reason why this should be true. The whole theory of separating banks and BHCs is to be sure that BHCs could fail without implicating or damaging the bank, and this has happened frequently. If a holding company of any kind fails, its subsidiaries can remain healthy, just as the subsidiaries of a holding company can go into bankruptcy without implicating the parent. If a holding company with many subsidiaries regulated by different regulators should go into bankruptcy, there is no apparent reason why the subsidiaries cannot be sold off if they are healthy and functioning, just as Lehman's broker-dealer subsidiary was sold to Barclays Bank immediately after Lehman declared bankruptcy. If there is some conflict between regulators, these—like conflicts between creditors—would be resolved by the bankruptcy court. Moreover, if the creditors, regulators, and stakeholders of a company believe that it is still a viable entity, chapter 11 of the Bankruptcy Code provides that the enterprise can continue functioning as a "debtor in possession" and come out of the proceeding as a slimmed-down and healthy business. Several airlines that are functioning today went through this process, and—ironically—some form of prepackaged bankruptcy that will relieve the auto companies of their burdensome obligations is one of the options the administration is considering for that industry. (Why bankruptcy is considered workable for the auto companies but not financial companies is something of a mystery.) In other words, even if it were likely to be effective and efficient—which is doubtful—a special resolution procedure for financial firms is unlikely to achieve more than the bankruptcy laws now permit.

In addition to increasing the likelihood that systemically important firms will be bailed out by the government, the Geithner resolution plan will also raise doubts about priorities among lenders, counterparties, shareholders, and other stakeholders when a financial firm is resolved or rescued under the government's control, rather than in a bankruptcy proceeding. In bankruptcy, a court decides how to divide the remaining resources of the bankrupt firm. Even in an FDIC resolution, insured depositors have a preference. It is not clear who would get bailed out and who would take losses under the administration's plan. In any event, the current bankruptcy system is regarded as potentially "disorderly," although why a resolution by a government agency will be more orderly has not been specified. In any event, it is likely that favored constituencies will seek, and probably get, more of the available funds in a windup or a bailout carried out by a government agency than they would in a normal bankruptcy. Given that bailouts are going to be much more likely than liquidations, especially for systemically important firms, a special government resolution or rescue process will also undermine market discipline and promote more risk-taking in the financial sector. In bailouts, the creditors will be saved in order to prevent a purported systemic breakdown, reducing the risks that creditors believe they will be taking in lending to systemically important firms. Over time, the process of saving some firms from failure will weaken all firms in the financial sector. Weak managements and bad business models should be allowed to fail. That makes room for better managements and better business models to grow. Introducing a formal rescue mechanism will only end up preserving bad managements and bad business models that should have been allowed to disappear while stunting or preventing the growth of their better-managed rivals. Finally, as academic work has shown again and again, regulation suppresses innovation and competition and adds to consumer costs.

With all these deficiencies in the administration's plan for creating systemically important companies—together with a special liquidation or bailout system as an alternative to bankruptcy—it is useful to consider the administration's rationale for such an extraordinary change in the financial sector's structure and competitive conditions. It appears, in this connection, that the administration is resting its case on only two events—the failure of Lehman Brothers and the rescue of AIG—as the reasons for advancing its extraordinary plan. Both examples, as discussed below, are inapposite. AIG should not have been rescued—saving the taxpayers $200 billion—and Lehman's failure was not the disruptive incident that has been portrayed in the media and elsewhere. Indeed, if the market had been functioning normally when Lehman failed, its failure, like Drexel Burnham Lambert's in 1990, would have caused little market disruption.

The Exaggerated Significance of AIG and Lehman

Secretary Geithner has defended his proposal by arguing that, if it had been in place, the rescue of AIG last fall would have been more "orderly" and the failure of Lehman Brothers would not have occurred. Both statements might be true, but would that have been the correct policy outcome? Recall that the underlying reason for the administration's plan to designate and specially regulate systemically important firms is that the failure of any such company would cause a systemic event—a breakdown in the financial system and perhaps the economy as a whole. Using this test, it is clear at this point that neither AIG nor Lehman is an example of a large firm creating systemic risk.

In a widely cited paper, John Taylor of Stanford University concluded that the market meltdown and the freeze in interbank lending that followed the Lehman and AIG events in mid-September 2008 did not begin until the Treasury and Fed proposed the initial Troubled Asset Relief Program funding later in the same week, an action that suggested (along with then–treasury secretary Henry M. Paulson's warnings of imminent doom) that financial conditions were much worse than the markets had thought.[5] Taylor's view, then, is that AIG and Lehman did not have any causal relationship to the meltdown that occurred later that week.

Since neither firm was a bank or other depository institution, this is highly plausible. Few of their creditors were expecting to be able to withdraw funds on demand to meet payrolls or other immediate expenses, and later events and data have cast doubt on whether the failure of Lehman or AIG (if it had not been bailed out) would have caused the losses many have claimed. Advocates of broader regulation frequently state, and the media dutifully repeat, that the financial institutions are now "interconnected" in a way that they have not been in the past.

This idea reflects a misunderstanding of the functions of financial institutions, all of which are intermediaries in one form or another between sources of funds and users of funds. In other words, they have always been interconnected in order to perform their intermediary functions. The right question is whether they are now interconnected in a way that makes them more vulnerable to the failure of one or more institutions than they have been in the past, and there is no evidence of this. The sections below strongly suggest that there was no need to rescue AIG and that Lehman's failure was problematic *only because* the market was in an unprecedentedly fragile and panicky state in mid-September 2008.

Financial firms have always been interconnected in order to perform their intermediary functions. The right question is whether they are now interconnected in a way that makes them more vulnerable to the failure of one or more institutions than they have been in the past, and there is no evidence of this.

AIG Should Have Been Sent to Bankruptcy. AIG's quarterly report on Form 10-Q for the quarter ended June 30, 2008—the last quarter before its bailout in September—shows that the company had borrowed, or had guaranteed subsidiary borrowings, in the amount of approximately $160 billion, of which approximately $45 billion was due in less than one year.[6] Very little of this $45 billion was likely to be immediately due and payable, and thus, unlike a bank's failure, AIG's failure would not have created an immediate cash loss to any significant group of lenders or counterparties. Considering that the international financial markets are more than $12 trillion, the $45 billion due within a year would not have shaken the system. Although losses would eventually have occurred to all those who had lent money to AIG, they would have occurred over time and been worked out in a normal bankruptcy proceeding, after the sale of its profitable insurance subsidiaries.

Many of the media stories about AIG have focused on the AIG Financial Products subsidiary and the obligations that this group assumed through credit default swaps (CDSs). However, it is highly questionable whether there would have been a significant market reaction if AIG had been allowed to default on its CDS obligations in September 2008. CDSs—although they are not insurance—operate like insurance; they pay off when there is an actual loss on the underlying obligation that is protected by the CDS. It is much the same as when a homeowners' insurance company goes out of business before there has been a fire or other loss to the home. In that case, the homeowner must go out and find another insurance company, but he has not lost anything except the premium he has paid. If AIG had been allowed to default, there would have been little if any near-term loss to the parties that had bought protection; they would simply have been required to go back into the CDS market and buy new protection. The premiums for the new protection might have been more expensive than what they were paying AIG, but even if that were true, many of them had received collateral from AIG that could have been sold in order to defray the cost of the new protection.[7] CDS contracts normally require a party like AIG that has sold protection to post collateral as assurance to its counterparties that it can meet its obligations when they come due.

This analysis is consistent with the publicly known facts about AIG. In mid-March, the names of some of the counterparties that AIG had protected with CDS became public. The largest of these counterparties was Goldman Sachs. The obligation to Goldman was reported as $12.9 billion; the others named were Merrill Lynch ($6.8 billion), Bank of America ($5.2 billion), Citigroup ($2.3 billion), and Wachovia ($1.5 billion).[8] Recall that the loss of CDS coverage—the obligation in this case—is not an actual cash loss or anything like it; it is only the loss of coverage for a debt that is held by a protected party. For institutions of this size, with the exception of Goldman, the loss of AIG's CDS protection would not have been problematic, even if they had in fact already suffered losses on the underlying obligations that AIG was protecting. Moreover, when questioned about what it would have lost if AIG had defaulted, Goldman said its losses would have been "negligible." This is entirely plausible. Its spokesman cited both the collateral it had received from AIG under the CDS contracts and the fact that it had hedged its AIG risk by buying protection against AIG's default from third parties.[9] Also, as noted above, Goldman only suffered the loss of its CDS coverage, not a loss on the underlying debt the CDS was supposed to cover. If Goldman, the largest counterparty in AIG's list, would not have suffered substantial losses, then AIG's default on its CDS contracts would have had no serious consequences in the market. This strongly suggests that Secretary Geithner's effort to justify the need for a systemic regulator is based on very weak or exaggerated data. AIG could have been put into bankruptcy with no costs to the taxpayers. A systemic regulator would have rescued AIG—just as the Fed did—amounting to an unnecessary cost for U.S. taxpayers and an unnecessary windfall for AIG's counterparties. We will probably never know why the Fed decided to bail out AIG, but the most likely reason is that it simply panicked at the market's reaction to the Lehman failure.

Lehman's Failure Did Not Cause a Systemic Event. Despite John Taylor's analysis, it is widely believed that Lehman's failure proves that a large company's default, especially when it is "interconnected" through CDSs, can cause a systemic breakdown. For that reason, Secretary Geithner contends, there should be some authority in the government to seize such a firm and keep its failure from affecting others. Even if we accept, contrary to Taylor, that Lehman's failure somehow precipitated the market freeze that followed, it does not support the proposition that, in a normal market, Lehman's failure would have caused a systemic breakdown. In fact, analyzed in light of later events, it is evidence for the opposite conclusion. First, after Lehman's collapse, there is only one example of any other organization encountering financial difficulty because of Lehman's default. That example is the Reserve Fund, a money market mutual fund that held a large amount of Lehman's commercial paper at the time Lehman defaulted. This caused the Reserve Fund to "break the buck"—to fail to maintain its share price at exactly one dollar—and it was rescued by the Treasury. The fact that there were no other such cases, among money market funds or elsewhere, demonstrates that the failure of Lehman in a calmer and more normal market would not have produced any significant knock-on effects. In addition, when Lehman's CDS obligations were resolved a month after its bankruptcy, they were all resolved by the exchange of only $5.2 billion among all the counterparties, a minor sum in the financial markets and certainly nothing that in and of itself would have caused a market meltdown.[10]

So, what relationship did Lehman's failure actually have to the market crisis that followed? The problems that were responsible for the crisis had actually begun more than a year earlier, when investors lost confidence in the quality of securities—particularly mortgage-backed securities (MBS)—that had been rated AAA by rating agencies. As a result, the entire market for asset-backed securities of all kinds became nonfunctional, and these assets simply could not be sold at anything but a distress price. Under these circumstances, the stability and even the solvency of most large financial institutions—banks and others that held large portfolios of MBS and other asset-backed securities—were in question.

In this market environment, Bear Stearns was rescued through a Fed-assisted sale to JPMorgan Chase in March 2008. The rescue was not necessitated because failure would have caused substantial losses to firms "interconnected" with Bear, but because the failure of a large financial institution in this fragile market environment would have caused a further loss of confidence—by investors, creditors, and counterparties—in the stability of *other* financial institutions. This phenomenon is described in a 2003 article by George Kaufman and Kenneth Scott, who write frequently on the subject of systemic risk. They point out that when one company fails, investors and counterparties look to see whether the risk exposure of their own investments or counterparties is similar: "The more similar the risk-exposure profile to that of the initial [failed company] economically, politically, or otherwise, the greater is the probability of loss and the more likely are the participants to withdraw funds as soon as possible. The response may induce liquidity and even more fundamental solvency problems. This pattern may be referred to as a 'common shock' or 'reassessment shock' effect and represents *correlation without direct causation*."[11] In March 2008, such an inquiry would have been very worrisome; virtually all the large financial institutions around the world held the same assets that drove Bear toward default.

Although the rescue of Bear temporarily calmed the markets, it led to a form of moral hazard—the belief that in the future governments would rescue all financial institutions larger than Bear. Market participants simply did not believe that Lehman, just such a firm, would *not* be rescued. This expectation was shattered in September 2008 when Lehman was allowed to fail, leading to exactly the kind of reappraisal of the financial health and safety of other institutions described by Kaufman and Scott. That is why the market froze at that point; market participants were no longer sure that the financial institutions they were dealing with would be rescued, and thus it was necessary to examine the financial condition of their counterparties much more carefully. For a period of time, the world's major banks would not even lend to one another. So what happened after Lehman was not the classic case of a large institution's failure creating losses at others—the kind of systemic risk that has stimulated the administration's effort to regulate systemically important firms. It was caused by the weakness and fragility of the financial system that began almost a year earlier, when the quality of MBS and other asset-backed securities was called into question and became unmarketable. If Lehman should have been bailed out, it was not because its failure would have caused losses to others—the reason for the designation of systemically important firms—but because the market was in an unprecedented condition of weakness and fragility.

Thus, the two examples that Secretary Geithner has used to push his plan are inapposite. AIG should clearly have been sent to bankruptcy court, and Lehman's failure was only important because it caused market participants to reappraise the risks of dealing with one another in an unprecedented market environment—in which almost every large financial institution was already weak and possibly insolvent. Regrettably, the administration is using these two inapposite examples—its only examples—to set in place an entirely new, broader, and wholly unnecessary system of regulation and resolution. In the unlikely event that the worldwide financial markets in the future were to again become fragile and fearful, it would be far better to have an ad hoc response from the U.S. government than to establish a vast new regulatory structure today for an event that is a wildly remote possibility.

Regulation adds costs and reduces competition and innovation. If it does not produce outcomes that are better than market discipline—and it certainly has not when we compare unregulated hedge funds and regulated banks—it should not be imposed on industries in which government backing is not present.

The Weak Case for Designating Systemically Important Firms

Even if there were facts that made it sensible to designate systemically important companies today and create a special system of resolution for them, major questions would still be unresolved.

How Would Systemically Important Firms Be Identified? Even if a systemic event could be caused by the failure of a systemically important firm, how would we identify such a firm in advance? Secretary Geithner has cited numerous criteria in addition to size, including reliance on short-term funding or whether it is a source of credit for households.[12] There are no examples of a large financial institution's failure actually causing a systemic event for the simple reason that, in every case of a large bank's failure, it has been bailed out. When other kinds of financial institutions have failed, no systemic disruption has occurred. In theory, for the reasons outlined earlier, the failure of a large bank could result in a systemic breakdown, but on what basis would nonbanks be designated as systemically important? Experience provides no answer. Making things tougher for the proponents of the administration's plan is the fact that the only examples we have contradict their assumptions. Not only have large nonbank financial institutions such as Drexel Burnham failed without causing a systemic event, but the failure of quite small firms have caused what some might consider systemic events, even though no one would have classified them as systemically important in advance. For example, when two tiny securities dealers—Bevill, Bresler and ESM—failed in the mid-1980s, Paul Volcker, then chairman of the Federal Reserve Board, told Congress: "The failure of some dealers operating at the periphery of the market . . . did have severe repercussions for some customers. The insolvency of a number of thrift institutions was precipitated, while other institutions involved in financing or servicing the fringe dealers were placed in some jeopardy. In our highly interrelated and interdependent financial markets, these developments carried at least the seeds of more widespread systemic problems."[13] This comment provides an indication of how malleable the concept of systemic risk can be. In another well-known case, the 1976 failure of Herstatt Bank, a small German bank, caused a breakdown in the international payment system, although Herstatt would not have been on anybody's list of systemically important institutions when it failed.[14] What the Herstatt case shows is that regulating systemically important firms does not provide any assurance that systemic risk will be avoided. It creates the dangers to competition discussed above, suppresses innovation, and raises costs, but it does not make the financial system materially safer.

Anyway, Would Regulation Work? Even if we assume that it is possible to determine in advance which firms will cause systemic risk, would regulation prevent it? Although this idea is central to the administration's case, all the evidence we have points the other way: regulation is simply not effective in preventing risk-taking and failure. The evidence is too clear to be ignored. After the S&L debacle in the late 1980s and early 1990s—a financial crisis in which most of the S&L industry as well as almost 1,600 commercial banks failed—Congress adopted FDICIA. At the time, this legislation was considered extremely tough banking legislation—so much so that, in a speech to a conference at the Federal Reserve Bank of Chicago in 1992, Alan Greenspan, then chairman of the Federal Reserve Board, complained that the law created too many restrictions on banks.[15] Greenspan might have had it right; sixteen years after the adoption of FDICIA, we entered the worst U.S. banking crisis since the Depression, and perhaps the worst of all time.

This does not say much for the effectiveness of regulation, and it certainly does not provide a basis for believing that if we were to extend safety-and-soundness regulation beyond banks to other areas of the financial sector, we would be doing anything to prevent another crisis in the future. Indeed, there is significant evidence that regulation introduces moral hazard and makes the failure or weakness of regulated entities more likely. One example of this is the contrast between hedge funds—unregulated as to safety and soundness—and commercial banks, which are heavily regulated for this purpose. Hedge funds have long been targets for lawmakers looking for opportunities to impose new regulations.[16] Yet, the current crisis was caused by regulated banks, not hedge funds, and although some hedge funds have failed, no hedge funds have had to be bailed out by the government because they might create systemic risk. Moreover, hedge funds have performed much better than regulated banks in protecting their investors against losses. As Houman Shadab testified recently before Congress: "Even throughout 2008, while hedge funds have experienced the worst losses in their entire history as an industry, they have still managed to shield their investors' wealth from the massive losses experienced by mutual funds and the stock market more generally. From January through October 2008, the U.S. stock market lost 32 percent of its value while the average hedge fund lost approximately 15.48 percent."[17] Bank stocks, of course, have performed worse than the stock market as a whole.

It is difficult, then, to escape the conclusion that regulation would not achieve any of the objectives that the administration has set out for it and that the motivation to broaden regulation and extend it to other areas of the financial economy is ideological, rather than based on facts, evidence, or even experience. Regulation adds costs and reduces competition and innovation. If it does not produce outcomes that are better than market discipline—and it certainly has not when we compare unregulated hedge funds and regulated banks—it should not be imposed on industries in which government backing is not present.

Finally, the proponents of systemic regulation argue that the administration's plan should be adopted because we have already bailed out so many firms that it is impossible to return to a world in which there is no systemic regulation. In other words, the moral hazard already created by the bailouts that have occurred justifies new and broader regulation. The cat, as they say, is out of the bag. Leaving aside the absurdity of the government getting more power because it made errors in the use of the power it had already been given, the trouble with this argument is that it treats the current financial crisis as an event that is likely to recur in the future. However, this crisis—involving as it does all developed countries and virtually all major financial institutions—is an unprecedented event that has required unprecedented actions by the government. To use the current crisis as a basis for a major policy change like that which the administration has proposed, it is necessary to believe that a worldwide meltdown of financial institutions will be a routine event in the future. But given the fact that nothing like this has ever happened before, there is no reason to believe that after the current crisis is over the financial markets will continue to expect bailouts of large nonbank financial institutions.

A useful analogy is the Fed's current role in addressing the problems of the financial sector. Because of the severity of the crisis, the Fed has been working hand in glove with the Treasury Department to provide funds for bank rescues and bailouts. If the markets were to take this co-operation as a precedent for the way the Fed will act in the future, they could well conclude that the Fed is no longer a truly independent central bank. However, most people in the financial markets probably understand that the Fed's extraordinary actions today will not create precedents for the future and that, when the current crisis is over, the Fed will act to show its independence of the Treasury, with its reputation for objectivity in its decision-making undiminished.

The Fed and Treasury are well aware of this problem and recently issued a joint statement pointing out that "[a]ctions that the Federal Reserve takes, during this period of unusual and exigent circumstances, in pursuit of financial stability . . . must not constrain the exercise of monetary policy."[18] In other words, the mere fact that some extraordinary and unprecedented actions had to be taken to deal with this crisis does not mean that everything in our financial system has changed. The same is true for the structure of the financial system itself. It should be designed for what is likely to occur in the future, not for a situation like the current unprecedented crisis.

Conclusion

The administration is attempting to build a case for a wholesale restructuring of the financial markets on the basis of two inapposite examples—AIG and Lehman. The fundamental changes its plan entails—the establishment of a powerful regulator with the authority to designate certain firms as systemically important and a system for resolving or rescuing financial institutions other than banks—will seriously impair competition in the financial sector and threaten to create large companies that are not significantly different in their competitive effect from Fannie Mae and Freddie Mac. Up to now, there has been little resistance from the financial sector, but the administration's case for this vast change in financial regulation is so weak—and the result of implementing its plan so troubling—that concerted financial industry opposition is likely to develop.

Notes

1. Timothy F. Geithner, written testimony (Committee on Financial Services, U.S. House of Representatives, March 26, 2009), available at www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf (accessed April 8, 2009).

2. See Damian Paletta, "U.S. to Toughen Finance Rules," *Wall Street Journal*, March 16, 2009.

3. See, for example, Peter J. Wallison, "Risky Business: Casting the Fed as a Systemic Risk Regulator," *Financial Services Outlook* (February 2009), available at www.aei.org/publication29439.

4. Calculation by the author, based on Federal Deposit Insurance Corporation press releases and available upon request.

5. John B. Taylor, "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong" (Working Paper 14,631, National Bureau of Economic Research, Cambridge, MA, January 2009), 25ff, available at www.nber.org/papers/w14631 (accessed April 8, 2009).

6. American International Group, 10-Q filing, June 30, 2008, 95–101.

7. A full description of the operation of credit default swaps appears in Peter J. Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told," *Financial Services Outlook* (December 2008), available at www.aei.org/publication29158.

8. Mary Williams Walsh, "A.I.G. Lists Banks It Paid with U.S. Bailout Funds," *New York Times*, March 16, 2009.

9. Peter Edmonston, "Goldman Insists It Would Have Lost Little if A.I.G. Had Failed," *New York Times*, March 21, 2009.

10. See Peter J. Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told."

11. George G. Kaufman and Kenneth Scott, "What Is Systemic Risk and Do Regulators Retard or Contribute to It?" *The Independent Review* 7, no. 3 (Winter 2003). Emphasis added.

12. Timothy F. Geithner, written testimony, March 26, 2009.

13. Paul A. Volcker, statement (Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, June 26, 1985), 1–2.

14. George G. Kaufman and Kenneth Scott, "What Is Systemic Risk and Do Regulators Retard or Contribute to It?" 11–12.

15. Alan Greenspan, remarks (Twenty-Eigth Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 7, 1992), available at http://fraser.stlouisfed.org/historicaldocs/ag92/download/27852/Greenspan_19920507.pdf (accessed April 8, 2009).

16. See, for example, Senate Finance Committee, "Grassley Seeks Multi-Agency Response on Lack of Hedge Fund Transparency, Expresses Alarm at Risk to Pension-Holders," news release, October 16, 2006, available at www.senate.gov/~finance/press/Gpress/2005/prg101606.pdf (accessed February 4, 2008).

17. Houman B. Shadab, testimony (Committee on Oversight and Government Reform, U.S. House of Representatives, November 15, 2008).

18. Board of Governors of the Federal Reserve System and U.S. Department of the Treasury, "The Role of the Federal Reserve in Preserving Financial and Monetary Stability," news release, March 23, 2009, available at www.federalreserve.gov/newsevents/press/monetary/20090323b.htm (accessed April 2, 2009).